

Docket No 00-0476

Exhibit No. Joint Applicants Ex 10

Date: \_\_\_\_\_

REBUTTAL TESTIMONY OF

**PAUL G. TOWNSLEY**

ON BEHALF OF

CITIZENS UTILITIES COMPANY OF ILLINOIS

OFFICIAL FILE

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Joint Applicants EXHIBIT NO. 10

Witness \_\_\_\_\_

Date 1-31-01 Reporter and

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**Background and Qualifications**

**Q1. Please state your name and business address.**

A1. My name is Paul G. Townsley. My business address is 1300 South Yale Street, Flagstaff, Arizona 86001.

**Q2. By whom are you employed and in what capacity?**

A2. I am employed by Citizens Communications Company ("Citizens"), as Vice President, Citizens Water Resources.

**Q3. Please describe your current duties and responsibilities.**

A3. I have the responsibility for all of Citizens' water and wastewater business units. In addition to Illinois, these operations are in Arizona, California, Indiana, Ohio and Pennsylvania. My responsibility includes operations, maintenance, customer service, personnel, construction, planning and budgeting.

**Q4. Please summarize your educational background.**

A4. I am a graduate of the United States Merchant Marine Academy, with a Bachelor of Science Degree in Engineering in 1980. I am a registered professional engineer in mechanical engineering in the States of Hawaii and Arizona.

**Q5. Please describe your work experience.**

A5. In 1982, I joined Citizens' Kauai Electric Division. During the period until 1994, I was in charge first of its electric production department and then its electric transmission and

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20 distribution department for the isolated island utility. In 1994, I became Citizens' Vice  
21 President in charge of its Arizona Energy Division. During the next two years I was  
22 responsible for Citizens' natural gas and electric operations located in portions of  
23 northern and southern Arizona. In 1996, I became the Vice President of Citizens'  
24 Mohave Sector and was responsible for telecommunications, electric, natural gas, water  
25 and wastewater operations in Mohave County, Arizona. In 1997, I was named Vice  
26 President of Arizona Electric Division and was responsible of all of Citizens electric  
27 production, transmission, distribution and customer service in the State. In 1998, I  
28 assumed my current role.

29 **Q6. Have you previously testified before regulatory commissions?**

30 A6. Yes. I have provided testimony before the Arizona Corporation Commission and the  
31 Hawaii Public Utility Commission.

32 **Q7. What is the purpose of your testimony?**

33 A7. I will address why the acquisition by Illinois-American Water Company benefits CUCI  
34 ratepayers. My testimony demonstrates that one of the principal benefits to ratepayers is  
35 high quality water and wastewater service, and that to achieve that reality, you must have  
36 size and expertise. I also testify from my perspective that American Water Works  
37 Company, Inc. ("American") is the finest quality water provider in America and that  
38 Citizens' customers can only be well served by approval of the sale to an American  
39 subsidiary.

40 **Q8. [Question and answer deleted]**

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41 **Q9. Are you familiar with problems associated with small water companies?**

42 A9. Yes, I am aware in general of the problems of poor water quality, poor service, financial  
43 instability and operational weaknesses associated with small water companies. As this  
44 Commission is aware, small water companies mean large headaches for regulatory  
45 Commissions, and even larger problems for customers who live in their service areas,  
46 when these companies lack the expertise and financial resources required to provide safe  
47 and adequate service.

48 **Q10. How do the historical problems of small water companies impact this proposed**  
49 **transaction?**

50 A10. First, in these proceedings, there is an opportunity for a water/wastewater utility to  
51 emerge which has the size to be an important option for this Commission when  
52 addressing small water or wastewater companies. Although medium-sized companies  
53 like CUCI can occasionally attempt to address, resolve and absorb small troubled water  
54 and wastewater utilities, the reality is that a medium-sized company's probability of long-  
55 term success is much lower than that of a larger industry-specific organization. The  
56 magnitude of the capital and service improvements could be so great as to either make  
57 rates exorbitant to the customers of the small utility or negatively impact the remainder of  
58 a mid-sized company's customers. Although CUCI has successfully absorbed some  
59 small and/or troubled utilities in the past, on a prospective basis, Citizens has concluded  
60 that the existing and prospective needs of many small troubled water and wastewater  
61 utilities are too great and the company cannot logically pursue this course any longer in  
62 Illinois or elsewhere.

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63 In contrast, American, strengthened by its acquisitions, would have the size in Illinois to  
64 have sufficient synergies to regularly absorb troubled water/wastewater systems with  
65 minimal impact on underlying operations. American has a demonstrated record of being  
66 the country's leader in absorbing smaller entities, where it has sufficient size to be the  
67 major player in the state.

68 The public interest is clearly served by creation of a sufficiently sized entity that this  
69 Commission can turn to for professional, financially responsible intervention into  
70 troubled small water/wastewater companies.

71 **Q11. Is there presently a situation in northeastern Illinois involving small water**  
72 **companies, which illustrates the problems you have discussed?**

73 A11. Yes. It is my understanding that there is a group of five small water companies under  
74 common control which (1) have historically had service and quality complaints, and (2)  
75 are in serious financial trouble and are now for sale. Geographically, CUCI is closer to  
76 these small companies than Illinois-American or any of the other medium-sized water  
77 utilities in Illinois. However, given the concerns I discuss throughout my testimony, it is  
78 not an attractive option for Citizens to consider taking over these operations.

79 **Q12. Is the consolidation of the water/wastewater industry going on elsewhere?**

80 A12. Yes. Both in this country and around the world, the industry has recognized the need to  
81 achieve size and economies of scale. In Great Britain, as well as in other parts of Europe,  
82 water utilities are serving millions of customers, not simply hundreds of thousands of

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83 customers as proposed here. There is clearly recognition that if you are to have safe and  
84 high quality water provided for human consumption, one needs to have an entity of size.

85 Domestically, the same consolidation is occurring, as both the industry and regulators in  
86 other states have recognized that increased environmental and health concerns can only  
87 be addressed by larger entities.

88 **Q13. Is consolidation new to this Commission?**

89 A13. No. Clearly consolidation has occurred in the telecommunications, electric and gas  
90 industries. All of these have been driven by a number of factors, not the least of which  
91 are cost savings. The water and wastewater industry cannot be an exception, if one  
92 expects capital to continue to be secured on an economic basis.

93 **Q14. Are you stating that capital can be secured easier and at a lower cost with a larger  
94 entity?**

95 A14. Yes. It is my experience that larger water and wastewater corporate entities have lower  
96 cost debt and easier access to debt. We are all aware that the water/wastewater industry  
97 is the most capital intensive of the regulated industries. A Water Infrastructure Network  
98 ("WIN") report issued in March 2000 forecast that infrastructure replacement costs in the  
99 water and wastewater industry will approach \$1 trillion over the next 20 years.

100 **Q15. Why is the capital intensity of the water/wastewater industry increasing?**

101 A15. Continued consumer and society demands for higher water quality and a clean  
102 environment are leading to significantly more capital expense. The Safe Drinking Water

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103 Act and its subsequent amendments and interpretations have led to, or are leading to,  
104 standards in radon, arsenic, and disinfection by-products, for example, that previously  
105 were not measured at the same level, if at all. In another example, the U.S. EPA has  
106 recently promulgated a new standard requiring improved filtering operations to enhance  
107 the removal of cryptosporidium. There are definitely other standards that ultimately will  
108 be adopted dealing with serious water issues arising from further use of chemicals by  
109 society.

110 The Clean Water Act continues to impact the wastewater side of the business. For  
111 instance, regulatory initiatives in Illinois involving new measurement techniques, more  
112 stringent effluent ammonia limits, and a Total Maximum Daily Load ("TMDL") process  
113 on an individual stream basis are among the items which may require additional capital  
114 investments at significant levels. Thus, clearly the demands for capital are increasing  
115 with the demand for higher quality.

116 **Q16. Are you stating that it is getting tougher to serve customers quality water?**

117 A16. Yes. What was acceptable ten or fifteen years ago is not acceptable today. We, as a  
118 society, are more knowledgeable about the potential harm that comes from certain  
119 aspects of water; and the risk of contamination is far better understood today than it has  
120 been in the past.

121 **Q17. How does your concern about increasingly tougher water quality and environmental**  
122 **standards relate to this case?**

123 A17. My concern relates because I believe the Staff is incorrectly focusing on a very short-  
124 term view of least cost to ratepayers, given the factors I've discussed (Thomas Smith

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125       Testimony - Exhibit 1.0, page 14, lines 314-317). I believe this limitation to the present  
126       fails to grasp that the standards for quality water and wastewater service are moving very  
127       fast and that it is extremely difficult for a medium-sized water/wastewater company to  
128       keep up with the capital intensity of new regulations and requirements.

129       Prospectively, this industry is demanding greater expertise and greater capital infusion.  
130       Companies with medium-sized customer bases cannot keep up without either causing rate  
131       shock from the amounts of capital being spent and spread over a limited customer base or  
132       increased risk of regulatory non-compliance, because these new standards lead to  
133       increased amounts of testing. This increased testing is accompanied by exhaustive  
134       administration and record-keeping mandates that are difficult to consistently and  
135       correctly implement.

136       **Q18. Have these concerns impacted Citizens' decisions relating to the water/wastewater**  
137       **businesses?**

138       A18. Yes. Citizens has clearly stated that it is no longer willing to be in these businesses. Our  
139       company's abilities are being taxed because the amount of capital to meet ever increasing  
140       regulatory requirements is rising at such a rate as to soon be beyond our reach as a mid-  
141       sized company. For almost two years, Citizens has been explicitly clear in its intention to  
142       exit the water/wastewater industry and focus all of its resources in the  
143       telecommunications industry.

144       **Q19. Do companies in the water and wastewater industries need size to be able to meet**  
145       **regulatory requirements and survive?**



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146 A19. Yes, in my opinion.

147 **Q20. In your opinion, can Illinois-American Water Company address new proposed**  
148 **standards in the water and wastewater business more effectively and cheaper than**  
149 **CUCI?**

150 A20. Yes. American has the expertise, the testing knowledge level and the engineering  
151 expertise to be far more effective implementers of change and further has the ability to  
152 achieve economies of scale. The costs of ubiquitous compliance tasks prepared for a  
153 larger base of customers by an in-house team of experts should result in a reduced  
154 incremental cost. And American has nationally-recognized research facilities located in  
155 Illinois.

156 **Q21. Please comment on any cost of capital issues which you believe are relevant to this**  
157 **case.**

158 A21. Standard & Poor's ("S&P") long-term debt rating for Citizens was downgraded on  
159 October 26, 2000 from "single A-plus" to "single A-minus". S&P is retaining Citizens  
160 on CreditWatch with negative implications, even after the downgrade. S&P stated in its  
161 announcement that Citizens' ratings are likely to be further downgraded, depending on  
162 the extent to which the company permanently funds its pending Global Crossing Ltd.  
163 acquisition with debt.

164 On October 24, 2000, Moody's Investors Service lowered its long-term debt ratings of  
165 Citizens to Baa2 from A2. Moody's said that its actions reflect the strain on the  
166 company's debt protection measurements that will result from the cash acquisition of

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167 Global Crossing's local telephone business. This pending transaction is in addition to  
168 earlier announced acquisitions of access lines from U.S. West (now Qwest) and GTE  
169 (now Verizon). Clearly, the telecommunications industry is perceived to be more risky  
170 than the water/wastewater utility industry. This riskiness can equate to higher cost of  
171 debt, as well as a propensity for increased leveraging. In a pure water/wastewater utility,  
172 the tendency would be for a lower cost of debt.

173 **Q22. By announcing its intention to focus on telecommunications, are there other factors**  
174 **that influence Citizens' ability to continue to provide water and wastewater service?**

175 A22. Yes. Citizens was caught in a situation where consolidation was occurring in all four of  
176 its industries: telecommunications, electricity, natural gas, and water/wastewater. No one  
177 can maintain an expertise and competitiveness in four industries when one is a  
178 comparatively small player in each. Having chosen to grow in the telecommunications  
179 industry, the result has been some fall off in corporate expertise in the other business  
180 lines.

181 **Q23. With Citizens focusing on telecommunications, is it reasonable to assume no**  
182 **disruption in the workforce of its water and wastewater operations?**

183 A23. No. We are experiencing an exit of personnel throughout the water/wastewater sector.  
184 For example, key engineering personnel in Illinois, as well as regulatory, human resource  
185 and operations personnel in Illinois, Pennsylvania, California, and Arizona have been  
186 enticed to join other entities. New graduates and/or seasoned professionals are hesitant to  
187 come work for an entity that has officially communicated to the world its strategic intent

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188 to leave the industry. Consequently, time is not an ally of the regulatory process in this  
189 instance.

190 **Q24. Have any other State Public Utility Commissions approved Citizens'**  
191 **water/wastewater asset sales to American?**

192 A24. Yes. The Public Utilities Commission of Ohio, in Case Number 00-938-WS-ATR, dated  
193 September 7, 2000, approved the sale of Citizens' Ohio water and wastewater assets to  
194 Ohio-American Water Company, a subsidiary of American. On October 4, 2000, the  
195 Indiana Utility Regulatory Commission, in Case Number 41702, approved the sale of  
196 Citizens' Indiana water assets to Indiana-American Water Company, another subsidiary  
197 of American. More recently, staff of the Arizona Corporation Commission  
198 recommended that the Arizona Commission approve the sale of Citizens' Arizona water  
199 and wastewater assets to Arizona-American Water Company. Arizona Commission  
200 action is pending, with a draft Order expected about year end. In addition, a favorable  
201 decision from the Pennsylvania Public Utility Commission is anticipated by early 2001.

202 **Q25. What is your perception of American Water's reputation in the water industry?**

203 A25. American is, without a doubt, the best water service provider in the country today and has  
204 been so for a number of years. If we as a nation are truly serious about the importance of  
205 water quality to our own health and that of our families, we must permit the creation of  
206 entities that have as their primary business the provision of quality water and wastewater  
207 service. If we are going to achieve that quality at a price level that is tolerable, one needs  
208 to have an entity with the size and expertise to do the job.

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209 **Q26. Staff witness Roy King in his testimony (Exhibit 6.0, page 5, lines 14-18) states that**  
210 **he believes that Citizens would be able to provide adequate, reliable, efficient and**  
211 **safe service to Illinois customers if the asset sales are approved in all other states**  
212 **and this Commission denies the asset transfer. Do you agree with him?**

213 A26. No, not from a long-term / ongoing concern perspective. As I have stated earlier, it will  
214 become increasingly difficult to attract and retain the type of talent needed to operate this  
215 property professionally and cost-effectively, due to its uncertain future in Citizens'  
216 organization. The natural course of events will make providing service at current levels  
217 increasingly difficult as well as more costly.

218 As Citizens becomes an ever larger and more focused telecommunications business, and  
219 CUCI becomes a smaller and more remote island in the organization, management  
220 distraction from the needs of this particular business unit will inevitably increase. This  
221 operation will unavoidably become less core and more problematic to the Citizens  
222 organization at large.

223 I want to assure this Commission that Citizens would undertake all reasonable steps to  
224 manage its Illinois water operations efficiently and professionally. It simply will become  
225 ever more difficult to do so.

226 **Q27. Staff witness David Borden appears to indicate in his testimony (Exhibit 5.0, page 7,**  
227 **lines 143-154) that benefits from the proposed transaction do not justify the**  
228 **recovery of the acquisition adjustment from customers. In this regard, do you**  
229 **believe that American can provide benefits, beyond synergy savings, to Citizens'**  
230 **Illinois operations that Citizens itself cannot?**

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231 A27. Yes. As I have previously identified, it will become increasingly difficult for medium-  
232 sized water/wastewater companies like Citizens to keep up with the infrastructure  
233 replacement and regulatory requirements facing the industry. Larger and larger  
234 water/wastewater companies will be needed to step up to these challenges in the future.

235 In addition, due to its size and position in the industry, American can bring numerous  
236 near term and long term service enhancements to Citizens' water/wastewater customers  
237 in Illinois.

238 **Q28. Do you have any concluding thoughts?**

239 A28. Yes. Substantial economies of scale have been realized in combining  
240 telecommunications and energy utilities. Unfortunately, significant economies of scale  
241 across the water/wastewater industry have not been realized, because of the industry's  
242 significant and chronic fragmentation. In this proceeding, the Commission has an  
243 opportunity to positively address this situation and to take corrective action through  
244 approval of the acquisition.

245 Water and wastewater utilities are facing higher treatment costs to comply with the Safe  
246 Drinking Water Act and Clean Water Act. By their very nature, these costs are pushing  
247 the need to achieve economies of scale.

248 Citizens recognized this reality in making its strategic decisions and as a consequence  
249 secured a top quality firm with sufficient size and expertise to own and operate its water  
250 and wastewater operations.

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251   **Q29. Does that conclude your rebuttal testimony?**

252   A29. Yes.